

A YEAR OF
BUILDING
FOR THE
FUTURE.

1999
ANNUAL
REPORT

Corporate Overview

Pelorus Navigation Systems Inc. designs, manufactures, installs and maintains navigational equipment for the aviation industry.

In its seventeen year history, the Company has earned its reputation for innovation, quality and product reliability with equipment installations on six continents.

The tradition of innovation continues today with the Company's lead product, the GPS-based Honeywell/Pelorus SLS-2000, the world's first FAA Type Approved satellite landing system for aircraft. Regulatory agencies worldwide are now in the process of defining the standards which will allow the use of this technology for civil aviation purposes. Pelorus also manufactures, markets and installs Distance Measuring Equipment for airports, helicopter landing pads and marine platforms. Manufacturing facilities are located in Calgary, Alberta, and Saskatoon, Saskatchewan. The corporate office is located in Calgary.



PELORUS NAVIGATION SYSTEMS INC.

ASE: PN

Contents

Introduction	1
President's Report	4
Management's Discussion & Analysis	7
Auditors' Report	9
Consolidated Financial Statements	10
Notes to Consolidated Financial Statements	13
Corporate Information	Inside Back Cover

Stock Exchange Listing

Alberta Stock Exchange: PN

Fiscal Year-End

May 31

Acronyms

AWOS	Automated Weather Observation (and Reporting) System
DME	Distance Measuring Equipment
EUROCAE	European Organization for Civil Aviation Equipment
FAA	Federal Aviation Administration (U.S.)
GBAS	Ground Based Augmentation System
GLONASS	Global Navigation Satellite System (Russia's satellite system)
GLS	GNSS Landing System
GNSS	Global Navigation Satellite System
GPS	Global Positioning System (United States' satellite system)
ICAO	International Civil Aviation Organization
ILS	Instrument Landing System
LAAS	Local Area Augmentation System
RTCA	Radio Technical Commission for Aeronautics
SCAT-I	Special Category-I (FAA certification category)
SLS	Satellite Landing System
WAAS	Wide Area Augmentation System

Notice of Annual Meeting

The Annual General Meeting of the shareholders of Pelorus Navigation Systems Inc. will be held at 3:00 pm, Wednesday, October 20, 1999, at The Westin Hotel, 320 - 4th Avenue S.W., Calgary, Alberta, Canada. Shareholders and others interested in the affairs of the company are welcome to attend.

Introduction

September 21, 1998 ...

When Continental Airlines Flight 9980 from Washington, DC landed on the tarmac at Newark, New Jersey, it was the first commercial passenger jet to use a satellite landing system. Completing its historic flight, Continental 9980 then took off for Minneapolis/St. Paul, the second major U.S. airport to be equipped with the Honeywell/Pelorus SLS-2000 system.



Newark, New Jersey

The highlight of Pelorus' fiscal 1999, this event firmly established the leadership position of the Honeywell/Pelorus team in the development of the next generation of navigation technology for the world's aviation industry.

Despite what seems to be a frustrating and lengthy process, real progress is being made by civil aviation regulatory authorities to validate and approve the standards that will define the worldwide use of global positioning landing systems (GLS). Honeywell and Pelorus expect to commission the first GLS for public use in early 2001. Meanwhile, an upgradable version of the SLS-2000 is being installed at an increasing number of airports around the world.

The Leadership Position in an Emerging World Market

Strategically Positioned for Success

Pelorus and Honeywell joined forces in January 1995 to develop and manufacture a satellite landing system, integrating both air and ground station requirements, for precision approaches and landings. The relationship combines Honeywell's strong market presence as an avionics supplier, expertise in GPS, and worldwide product support capability with Pelorus' track record as a leading developer and installer of ground-based navigational systems.

The Global Opportunity

The FAA estimates there are 48,000 airports in the world that are candidates for satellite based landing systems. About 7,000 have commercial airline service and 1,000 have precision approach systems. This suggests an immediate, potential SLS market of 6,000 airports which, over the next 10 years, translates to a \$3 billion market.



SLS-2000 Installations Completed

*(As at August 22, 1999. * Indicates substantially completed.)*

Minneapolis/St. Paul, Minnesota
Newark, New Jersey
Saskatoon, Saskatchewan
Regina, Saskatchewan
White Sands, New Mexico
San Jose dos Campos, Brazil
U.S. Navy/U.S. Air Force
Kennedy Space Center, Florida*
Deer Valley, Arizona
Jackson Hole, Wyoming
Cedar Rapids, Iowa*
Norfolk Island, South Pacific*

SLS-2000 Installations In Progress

(Site work commenced as at August 22, 1999)

North America	7
Other	10

What They Are Saying

“Chicago O’Hare is the world’s busiest airport. We also have perhaps the most complex airfield geometry of any airport in the country, and this new satellite based navigational technology will not only allow us to preserve our capacity at the airport, it will allow us to be much more efficient.”

Mary Rose Loney

Commissioner of Aviation, Chicago O’Hare

“It’s new technology that allows a lot more flexibility for our onboard navigation systems. It allows us to pattern all approaches using the global positioning system and I believe that will give us much more flexibility and lower operating costs into all the airports that we currently operate in.”

Fred Abbott

Vice President Flight Operations, Continental Airlines

“GLS is the cornerstone to delay reduction at Newark and will enable Continental to move aircraft on schedule.”

Captain Jim Starley

Continental Airlines

“Certainly, if it’s the technology of choice, it will be installed both in our airports and many airports throughout the country. We think it probably will be and it’s something that will allow for us to be far more precise on approaches and departures and therefore use the airspace a lot better than we’re able to do now.”

Susan Baer, General Manager

Port Authority New York/New Jersey

Honeywell/Pelorus SLS

- The most advanced precision approach system in the world.
- Provides pilots with very precise navigation data to fly instrument approaches.
- More versatility and capability than existing instrument landing systems (ILS).
- Costs far less than traditional landing systems.
- Enhances aviation safety, improves traffic flow, increases runway availability, reduces weather delays.
- Serves all runway ends within a radius of 23 nautical miles at a fraction of the cost of a single ILS.

President's Report

Fellow Shareholders:

The past fiscal year was marked by steady progress toward our goal of becoming, with our partner Honeywell, the world's leading supplier of satellite-based landing systems for airports. While progress toward this goal was slower than anticipated, resulting in our financial results being below expectations, we remain confident of the potential the future holds.

Demand from airlines for the enhanced capabilities that satellite-based navigation and landing systems offer has not diminished. And the Honeywell/Pelorus team is still in the leadership position in the rapidly developing world market for this technology.

I have organized the remainder of my report as answers to key questions that I am frequently asked by Pelorus shareholders. I hope you find this an informative way to communicate with you.

Why has progress toward more widespread implementation of the SLS been so slow?

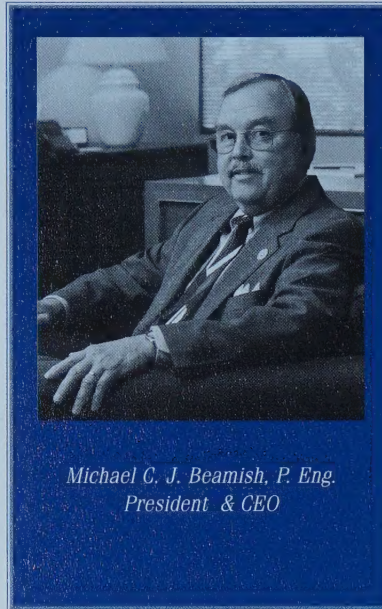
In aviation, safety is paramount. Before a new technology is adopted, there is an accepted, proven process that must be adhered to before it is entrusted for use in the public domain.

The process involves a rigorous validation of the fundamental concept, typically with prototype hardware and software. Once validated, written standards describing the requirements that the technology must meet are developed and then validated independently. The standards are approved, or revised and revalidated, and the technology is finally adopted. Then, the product that embodies the technology must be tested and approved before its use by the public.

From start to finish, this process typically takes six to 10 years.

Wasn't the Honeywell/Pelorus SLS already approved by the FAA?

The Honeywell/Pelorus SLS-2000 system which received Type Approval in 1997 and was certified at Newark and Minneapolis in 1998 was a restricted use Special Category I (SCAT-I) system. Our ground station, along with the avionics developed by Honeywell, went through all the steps described above.



*Michael C. J. Beamish, P. Eng.
President & CEO*

Initially, the FAA had planned that the transition to a system approved for full public use would occur in 2005. However, industry and the FAA decided that the transition to a full public use system should occur immediately. While this would significantly and rapidly increase the available market size, it meant accelerating the time frame for product enhancement and starting the design, approval and standards process all over again.

The impact on Pelorus of accelerating the time frame for implementation of the full public use system was a significant reduction in available market for the original SCAT-I Type Approved system, as customers opted to wait for the public use system. But, customers do not have to wait. We have modified the SLS-2000 to make it an upgradable system and it is available for sale now. It

will be available in its final configuration in early 2001. Avionics are expected to be available in the same time frame.

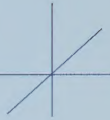
While the development of an upgradable system has been a positive response to the realities of the market, it also resulted in the write-off this year of \$1,018,052 of the product development costs incurred in the original development of the SCAT-I product. This represented the part of the technology that we could not carry forward into the next generation of the SLS-2000.

Everything seems to hinge on the FAA. When will its standard be ready?

As the FAA is the preeminent aviation authority in the world, its acceptance is critical. The FAA expects to publish its standard for the GLS ground station in mid September, 1999. Then there are two or three more standards to be created and several approvals to obtain before the implementation of the public use GLS.

The International Civil Aviation Organization (ICAO) has published its draft standard for the GLS — which is equivalent to LAAS and is referred to by ICAO as a Ground Based Augmentation System (GBAS). The validation process for the ICAO standard is expected to be finished in late fall of 2000.

Preparation of the RTCA (formerly Radio Technical Commission for Aeronautics) standard, which covers the airborne part of the system (the avionics), appears to be on schedule for completion early this fall. Although this is a U.S.-based organization, almost all other countries as well as the ICAO use and accept RTCA and FAA standards for airborne equipment. Avionics certified to RTCA and FAA standards are expected to be available by early 2001.



Is Pelorus involved in the standards process?

We continue to support and play an active role in the creation of the North American and world standards that drive our industry. While this represents a significant investment for a company of Pelorus' size, it is a vital part of our strategy to position our SLS product as the market leader. And, as noted above, significant progress was made on the standards development front during the past year.

Could something be done to speed things up?

The Government Industry Partnership (GIP) was inaugurated by the FAA to help speed up the implementation of public use LAAS. It is also helping raise the profile of the technology and the expectations of the customer, the airlines.

The FAA asked the Ground Station Manufacturers to form consortia consisting of at least one airline, one airport, one avionics manufacturer and one ground station manufacturer. The Honeywell consortium consists of almost all the major U.S. airlines, Boeing, more than 20 airports, all major avionics manufacturers and the Honeywell/Pelorus LAAS Ground Station. There is only one other consortium, led by the Raytheon Company.

Are there any viable competitors?

We firmly believe we have a substantial lead – in the number of installed systems, in our experience in obtaining the world's first Type Approval for a Differential GPS landing system, in the short lead time required to bring the next generation of our system to market, and in support from industry. The fact that the majority of the airlines and, very significantly, the largest aircraft manufacturer in the world, Boeing, are part of the Honeywell GIP consortium is a strong endorsement of the SLS-2000 technology.

How many sales of the SLS-2000 have actually been made?

To date, we have installed twelve SLS-2000 systems. In the current fiscal year, we plan to double that number.

During the past fiscal year, we completed the installation and flight testing of the SLS-2000 system at Jackson Hole, Wyoming, and substantially completed installations at Cedar Rapids, Iowa, Norfolk Island in the South Pacific, and Kennedy Space Center, Florida. In addition, we commenced site work for installations at seven airports in North America and ten outside North America.

No additional sales of the SLS-2000 system were made in fiscal 1999; however, shortly after year-end, we announced the receipt of a purchase order from Honeywell for eleven SLS-2000 Local Area Augmentation Systems (LAAS). All of these systems will be the upgradable, public-use configuration of the SLS-2000 and will be delivered and invoiced in the current fiscal year.

It is encouraging to note that more than half of the installations of the SLS-2000 this coming year will be outside North America. Again, this reflects a growing world market.

When will the first system for public use be ready?

We and Honeywell expect to commission the first GLS for public use in early 2001.

How is the Pelorus-Honeywell relationship?

Our partnership with Honeywell's Airport Systems continues to be strong and healthy. Airport Systems is a growth initiative within Honeywell Space & Aviation Controls' Commercial Aviation Systems division. Honeywell Space & Aviation Controls is the world's leading supplier of avionics for the commercial, military and space markets. Honeywell is committed to continuing its leadership – with Pelorus – in the world market for satellite based landing systems.

The full public-use satellite navigation and landing system has many different acronyms – LAAS, GLS and GBAS are the most common and they all mean approximately the same thing. LAAS (Local Area Augmentation Systems) is FAA terminology, GLS (Global satellite Landing System) is airline industry terminology, and GBAS (Ground Based Augmentation System) is ICAO terminology.

Basically they all refer to a **satellite-based ranging system consisting of a ground based system together with an airborne system.**

The **ground based system** embodies a high integrity differential GPS system that broadcasts differential corrections (with the required integrity, accuracy, continuity and availability for GPS and GPS look-alike satellites) and precision approach path information.

The **airborne system** uses the ground system's differential corrections to augment the raw GPS data and develops a precise, high integrity navigation solution in real time. The received precision approach path information allows the airborne system to compute a precise trajectory to follow for an approach and landing.

Precision
Approach & Landing
Decision Height

Category - I	200 feet
Category - II	100 feet
Category - III a	50 feet
Category - III b/c	0 feet

The term "precision approach" implies that both vertical and horizontal navigation guidance is available. If an aircraft is navigating and landing under Instrument Flight Rules (IFR), there are specified precision approaching landing categories that require the pilot to decide at predetermined points whether to continue the approach or to abort. There are three "so-called" categories; associated with each is a vertical and a horizontal visibility requirement. Category III is subdivided into a, b and c, with b and c having the same vertical visibility requirement.

In addition to the visibility requirements, there are also runway lighting and other airport infrastructure requirements associated with each category. The horizontal visibility measurement is made by an instrument mounted near the runway that measures the Runway Visible Range (RVR). The vertical visibility measurement is made by the pilot when the aircraft altimeter indicates the appropriate height above ground.

If the aircraft instruments and the airport infrastructure are capable of, say, CAT-I, when the altimeter in the aircraft indicates 200 feet above ground, if the pilot can see the ground and has the required horizontal visibility, the decision can be made to continue the approach. Otherwise, the decision is made to abort. CAT-III obviously requires more precision, integrity, continuity and availability of the navigation system than CAT-I.

A Special Category-I (SCAT-I) precision approach is restricted to those specifically approved to use it, unlike a "public use" approach which any aircraft and operator qualified to fly IFR may use.

Will Pelorus' relationship with Honeywell change if it merges with Allied Signal?

The proposed merger between the Allied Signal Corporation and Honeywell (with the merged entity to be called Honeywell International Inc.) will significantly strengthen Honeywell's aviation related business. We don't anticipate any changes in our contractual relationship as a result of the proposed merger.

What's happening with sales of DMEs?

Opportunities to compete for sales of our Distance Measuring Equipment (DME) system were few in fiscal 1999. Shortly after year end, we received a much anticipated order for five DMEs from NavCanada; these systems will be manufactured and delivered in the current fiscal year.

Recently, requests for DME quotations have picked up noticeably. Most of the renewed activity is coming from South East Asia, where the economies are recovering. We are well positioned to capitalize on such opportunities.

What is your strategy for the current year?

We expect that the past fiscal year will prove to be the last year of diminishing revenue. In 1999 our revenue of \$628,435 (versus \$2,136,372 for 1998) was certainly less than planned. Loss per share was slightly more than last year at \$0.39 (\$0.30 in fiscal 1998). In spite of more than a 50% reduction in our operating and G & A costs, our operating loss was slightly more in fiscal 1999 at \$1,386,896 versus \$1,226,604 in fiscal 1998. However, we have already received orders for the Honeywell/Pelorus SLS system and DME systems, and revenues from these sales will be included in the current fiscal year.

Our strategy for the next 12 to 18 months is to stay the course — continue to do what we've been doing and to actively seek opportunities to strengthen and diversify our company by developing or acquiring technology through acquisition or merger. During the past year, we investigated several potential opportunities and one is ongoing.

Thanks to the continued dedication and support of our employees and investors, we look forward to the future with confidence. I sincerely believe that, with patience and continued focus on our goal, we will achieve our potential.



Michael C. J. Beamish, P.Eng.
President & CEO

August 22, 1999

Calgary, Alberta

Management Discussion and Analysis of Results of Operations and Financial Condition

The following discussion and analysis of the financial condition and results of operations of Pelorus Navigation Systems Inc. (the "Company") for the years ended May 31, 1999 and 1998 should be read in conjunction with the audited financial statements.

RESULTS OF OPERATIONS

Revenue

Revenue for the year was \$628,435 compared to \$2,136,372 in 1998. In 1998 the Company recorded \$1,888,386 of revenue from the sale of Honeywell/Pelorus SLS systems. As discussed in the President's Message there were no additional sales of Honeywell/Pelorus SLS systems in 1999. Approximately \$401,000 of the 1999 revenue was related to the installation and training associated with these prior sales; the balance, \$227,852 (1998 - \$247,986) was attributable to monitoring our DME systems, sale of spare parts and modules, interest and other income.

Operating and Administrative Expenses

There are two components of Operating and Administrative Expenses: cost of goods sold and administration. Due to the narrow breadth of the Company's product line and the extremely competitive nature of our industry, it has been our policy to combine these components in order to keep a degree of confidentiality around our costing and profit margins for the benefit of the Company and our customers.

Operating and Administrative expenses for the year were \$1,330,643, a decrease of \$1,437,680 from 1998. Cost of goods sold decreased from 1998 as a result of there being no Honeywell/Pelorus SLS system sales in the current year. Cost of goods sold with respect to other product lines remained consistent with 1998. Administration expenses decreased substantially in 1999 as a result of a concerted effort by the Company to carefully control administration costs.

Selling Expense

Selling expense was \$435,442 in 1999, an increase of \$151,969 from 1998. These costs were incurred in support of Pelorus' marketing efforts for the DME product and for the Honeywell/Pelorus SLS system in Canada. Under the terms of our Teaming Agreement, Honeywell is responsible for marketing the Honeywell/Pelorus SLS system on a worldwide basis with the exception of Canada. Cycle time from the initial expenditure of marketing effort to revenue production in the early stages of the SLS product life is proving to be 18 to 24 months. During 1998 and 1999 certain costs incurred by Pelorus in support of Honeywell's international marketing efforts were capitalized. Those costs — related to capitalized marketing efforts for a now doubtful order of an SLS system — have been charged to Selling Expenses in 1999.

Product Development Costs

Our policy has been to amortize the Deferred Research and Development costs of \$3,080,481 incurred to develop the Honeywell/Pelorus SLS over the five year period following certification of the system by the FAA in August 1997. Amortization for 1999 includes an amount of \$1,018,052 which represents the remaining costs associated with technology research that has been superseded and that management has concluded is of no immediately realizable commercial value. As at May 31, 1999 the balance of \$995,060 in Deferred Research and Development costs remains to be amortized.

Costs associated with ongoing product development and enhancements with respect to existing products, primarily the Honeywell/Pelorus SLS system, and regulatory support activities are charged to Research and Development expense as incurred. In 1999 these costs were \$218,294 compared to \$275,937 in 1998.

Investment Tax Credits

We did not record any benefit associated with investment tax credits on the 1999 and 1998 balance sheets. In 1998 the Company wrote-off \$529,481 of tax credits previously accrued due to the uncertainty involved in the ultimate utilization of these credits. Notwithstanding the current uncertainty, these credits remain available to use in the appropriate circumstances in the future. Refer to Note 7 to the Financial Statements for further details.

LIQUIDITY AND CAPITAL RESOURCES

As at May 31, 1999 the Company had cash and cash equivalents of \$696,617 compared to \$1,452,496 at the end of fiscal 1998. The working capital surplus at the end of 1999 was \$1,589,601 versus \$2,851,462 at the end of 1998. No funds were raised in 1999 from the issue of share capital. In 1998, \$1,780,051 was raised through the exercise of warrants, agents' options and stock options.

Current year operations resulted in a cash flow deficiency of \$1,388,153 compared with a 1998 deficiency of \$1,226,604. When this increase in operating deficiency of \$161,549 is viewed in light of a \$1,507,937 decrease in sales from 1998, it demonstrates that the Company was successful in controlling expenditures, particularly administrative costs, during 1999.

The nature of the Company's customer orders is such that the manufacturing and assembly related to these orders are largely financed out of working capital, with payment received on or shortly after delivery. The quality of the customer base is such that the credit risk to the Company is low. Temporary increases in the levels of receivables, inventory and work-in-progress and the associated cash deficiency related to the recently announced orders from Honeywell and NavCanada will be financed by short-term bank borrowing.

At May 31, 1999 long-term debt was \$371,197, a reduction of \$71,048 from 1998.



RISK FACTORS AND CONSIDERATIONS

Year 2000

Being aware of the importance of this issue, management believes it has in place a program to mitigate the effects of the Year 2000 problem. The software and systems used by Pelorus are currently either Year 2000 compliant or have currently available patches and/or upgrades to allow them to become Year 2000 compliant. Each component product's compliance has been determined through public statements issued by the product manufacturer; any inaccuracies in these statements shall be the responsibility of that manufacturer.

Market Size

While Type Acceptance certification of the Honeywell/Pelorus SLS-2000 by the Federal Aviation Administration is an important development in the implementation of Differential Global Positioning System (DGPS) ground stations for precision approach and landing, the technology is, as yet, not an international standard. To become an international standard, the technology requires endorsement by the International Civil Aviation Organization (ICAO), a body of 185 member nations. The draft standard is currently being validated by the member nations and is scheduled to be completed in early 2001. In the United States, the Federal Aviation Administration (FAA) standards for public use of DGPS for precision approach and landing are expected to be implemented slightly in advance of the ICAO standards.

On operational and economic grounds, the case for a worldwide satellite-based navigational network is compelling. This year, the European Economic Community took concrete and positive steps towards implementing a European equivalent (called Galileo) to the US Global Positioning System (GPS) to be operational in 2008. While these steps are very encouraging, there are political and other considerations in the universal adoption of a DGPS-based navigational system. Pelorus and its teaming partner, Honeywell, are working diligently on relevant industry committees to provide test data and analysis on the use and performance of DGPS ground station technology. Adoption of DGPS by ICAO as a precision approach and landing standard is a qualifying factor in the ultimate size of the market for DGPS ground stations such as the Honeywell/Pelorus SLS.

Market Timing

Operational use of the Honeywell/Pelorus SLS requires that aircraft are equipped with appropriate DGPS avionics. Currently, the avionics that are commercially available are suitable for the latest generation of digital cockpit aircraft. Avionics that are priced and configured to meet the specific requirements of the ICAO and FAA standards for general aviation, and regional and commercial carrier operators are under development but not yet on the market. Wide-scale adoption of DGPS and sales of the Honeywell/Pelorus SLS may be conditioned by the timing of the availability of suitable avionics. To broaden market acceptance through increased

availability, Honeywell and Pelorus are collaborating with avionics manufacturers to encourage an accelerated introduction of DGPS airborne solutions for all aircraft types that use precision approach and landing systems.

Regulatory Issues

The US Federal Aviation Administration and the International Civil Aviation Organization are critically important participants in the process of establishing standards and getting equipment and systems approved for use in aviation. Schedule and approval risks are a real part of the development of a new navaid technology such as the SLS-2000. While we take prudent steps to mitigate these risks, we cannot eliminate them as these organizations are outside our control. In response to industry pressure, the FAA inaugurated the Government Industry Partnership (GIP) program in the spring of 1998 to help speed up the implementation of public use LAAS. It has also had the effect of helping to raise the profile of the technology as well as the expectations of the airlines. In addition to the Honeywell consortium that consists of almost all the major US airlines, Boeing, over 20 airports, all major avionics manufacturers and the Honeywell/Pelorus LAAS Ground Station, there is only one other consortium, led by the Raytheon Company, and it has far fewer participants than the Honeywell consortium. The fact that the majority of the major US airlines and, very significantly, Boeing are part of the Honeywell GIP consortium is a strong endorsement of the SLS-2000 technology and our belief that LAAS will become the Landing System of the future. Even with the FAA as a partner through the GIP program, schedule and approval risks are reduced, but not eliminated.

Product Development

The Honeywell/Pelorus SLS has been Type Approved by the Federal Aviation Administration as meeting the specification for Special Category I (SCAT-I) precision approach and landing. SCAT-I is the basis for the universal, public use standard. The standard, however, includes enhancements which require an investment in further development, testing and regulatory approval of the SLS. That development commenced in 1999 and should be complete in 2000.

Honeywell Relationship

Global adoption of a new technology such as the SLS requires a marketing effort well beyond the capacity of Pelorus' resources. Commercial success of the SLS is dependent on Honeywell's effectiveness and on Honeywell's continued commitment to the Honeywell/Pelorus program. Federal Aviation Administration certification of the Honeywell/Pelorus SLS-2000 in August 1997 is a testament to the solid alliance forged between the two companies in January 1995. Honeywell continues to commit the resources necessary to maintain their market leadership and enhance the system to meet the public use LAAS specifications, as do we. Pelorus is intent on performing our obligations under the Honeywell/Pelorus Teaming Agreement and doing what it takes within our capacity to support the SLS program and Honeywell's international marketing effort.

Auditors' Report

To the Shareholders of Pelorus Navigation Systems Inc.

We have audited the balance sheets of Pelorus Navigation Systems Inc. as at May 31, 1999 and 1998 and the statements of operations and deficit and changes in financial position for the years then ended. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with generally accepted auditing standards. Those standards require that we plan and perform an audit to obtain reasonable assurance whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation.

In our opinion, these financial statements present fairly, in all material respects, the financial position of the Company as at May 31, 1999 and 1998 and the results of its operations and the changes in its financial position for the years then ended in accordance with generally accepted accounting principles.



Chartered Accountants

Calgary, Alberta
July 19, 1999

Pelorus Navigation Systems Inc.

Balance Sheets

May 31	1999	1998
Assets		
Current		
Cash and term deposits	\$ 696,617	\$ 1,452,496
Accounts receivable (Note 1(a))	884,623	1,734,321
Inventory (Note 2)	365,558	535,794
Prepaid expenses	12,802	34,226
	<u>1,959,600</u>	<u>3,756,837</u>
 Deferred product development costs (Note 3)	 995,060	 2,588,258
 Capital assets (Note 4)	 <u>835,092</u>	 <u>1,068,280</u>
	<u>\$ 3,789,752</u>	<u>\$ 7,413,375</u>
 Liabilities and Shareholders' Equity		
Current		
Accounts payable	\$ 171,071	\$ 475,130
Current portion of long-term debt (Note 5)	198,928	430,245
	<u>369,999</u>	<u>905,375</u>
 Long-term debt (Note 5)	 <u>172,269</u>	 <u>12,000</u>
	<u>542,268</u>	<u>917,375</u>
 Share capital (Note 6)	 11,624,359	 11,624,359
 Contributed surplus (Note 6(d))	 356,808	 356,808
 Deficit	 (8,733,683)	 (5,485,167)
	<u>3,247,484</u>	<u>6,496,000</u>
	<u>\$ 3,789,752</u>	<u>\$ 7,413,375</u>

On behalf of the Board:



Director



Director

Pelorus Navigation Systems Inc.

Statements of Operations and Deficit

For the years ended May 31	1999	1998
Revenue		
Contract sales and services	\$ 577,014	\$ 2,069,338
Other	51,421	67,034
	<u>628,435</u>	<u>2,136,372</u>
Operating and administrative expenses	1,330,643	2,768,323
Selling expenses	435,442	283,473
Research and development expenses	218,294	275,937
Interest on long-term debt	30,952	35,243
	<u>2,015,331</u>	<u>3,362,976</u>
Loss before the undernoted	(1,386,896)	(1,226,604)
Amortization of capital assets	195,633	222,285
Amortization and write-down of deferred product development costs (Note 3)	1,593,198	492,223
Write-down of capital assets	72,789	-
Write-off of investment tax credits	<u>-</u>	<u>529,481</u>
Net loss for the year	(3,248,516)	(2,470,593)
Deficit, beginning of year	<u>(5,485,167)</u>	<u>(3,014,574)</u>
Deficit, end of year	<u>\$ (8,733,683)</u>	<u>\$ (5,485,167)</u>
Loss per share		
Basic	\$ (0.39)	\$ (0.30)
Fully diluted	<u>\$ (0.39)</u>	<u>\$ (0.30)</u>
Weighted average number of shares	<u>8,392,027</u>	<u>8,173,368</u>

Pelorus Navigation Systems Inc.

Statements of Changes in Financial Position

For the years ended May 31	1999	1998
Cash provided (used) by		
Operating activities		
Operations		
Net loss for the year	\$ (3,248,516)	\$ (2,470,593)
Items not involving cash		
Amortization of capital assets	195,633	222,285
Amortization and write-down of deferred product development	1,593,198	492,223
Write-off of investment tax credits	-	529,481
Write-down of capital assets	72,789	-
Gain on sale of capital asset	(1,257)	-
	<u>(1,388,153)</u>	<u>(1,226,604)</u>
Changes in non-cash working capital balances		
Accounts receivable	849,698	(950,858)
Inventory	170,236	528,087
Prepaid expenses	21,424	(6,558)
Accounts payable	(304,059)	328,748
Deferred revenue	-	(250,000)
	<u>(650,854)</u>	<u>(1,577,185)</u>
Financing activities		
Repayment of long-term debt	(71,048)	(87,786)
Issue of share capital, net	-	1,780,051
	<u>(71,048)</u>	<u>1,692,265</u>
Investing activities		
Purchase of capital assets	(35,777)	(47,054)
Increase in deferred development costs	-	(72,531)
Proceeds on disposal of capital assets	1,800	-
	<u>(33,977)</u>	<u>(119,585)</u>
Decrease in cash and equivalents	(755,879)	(4,505)
Cash and equivalents, beginning of year	<u>1,452,496</u>	<u>1,457,001</u>
Cash and equivalents, end of year	<u>\$ 696,617</u>	<u>\$ 1,452,496</u>
Represented by:		
Cash	\$ 196,178	\$ 452,363
Term deposits	<u>500,439</u>	<u>1,000,133</u>
	<u>\$ 696,617</u>	<u>\$ 1,452,496</u>

Pelorus Navigation Systems Inc.

Notes to Financial Statements May 31, 1999 and 1998

1. Significant Accounting Policies

The financial statements of the Company have been prepared by management in accordance with generally accepted accounting principles in Canada. The preparation of financial statements in conformity with generally accepted accounting principles requires management to make estimates and assumptions that affect the amounts reported in the financial statements and accompanying notes. Actual results could differ from those estimates. The financial statements have, in management's opinion, been properly prepared using careful judgement with reasonable limits of materiality and within the framework of the significant accounting policies summarized below.

(a) Revenue recognition

The Company recognizes revenue on manufacturing and installation contracts on the percentage of completion method. Percentage of completion is determined either as the proportion of costs incurred to expected contract costs, or is based on the percentage of labour to total expected labour costs. In applying the percentage of completion method, management evaluates each contract to determine the basis that best reflects the stage of completion for the particular contract. Included in accounts receivable are unbilled amounts of \$698,804 (1998 - \$954,650). These corresponding units built, pursuant to existing purchase orders, are 100% complete at May 31, 1999 but have not yet been delivered. As management expects to deliver all these units within the next fiscal year, the unbilled amounts have been shown as current receivables.

(b) Inventory

Inventory is recorded at the lower of cost and replacement value, which is not in excess of net realizable value. Cost is generally determined on a first-in, first-out basis.

Work in progress is recorded at the lower of cost and fair market value.

(c) Capital assets

Capital assets are recorded at cost, net of related investment tax credits.

Amortization is provided on assets in use during the year on the following basis:

Machinery and equipment	- 15% declining balance basis
Furniture and fixtures	- 20% declining balance basis
Automotive	- 30% declining balance basis
Leasehold improvements	- 17% straight line basis

The Company regularly reviews its capital assets to eliminate obsolete items.

(d) Foreign currency translation

Foreign currency accounts are translated to Canadian dollars as follows:

At the transaction date, each asset, liability, revenue or expense is translated into Canadian dollars by the use of the exchange rate in effect at that date. At the year end date, monetary assets and liabilities are translated into Canadian dollars by using the exchange rate in effect at that date and the resulting foreign exchange gains and losses are included in income in the current period.

Notes to Financial Statements – continued

1. Significant Accounting Policies - Continued

(e) Deferred product development costs

Product design and development costs in relation to the development of new products are deferred and capitalized net of investment tax credits claimed, if such credits are reasonably expected to be utilized. These costs include design costs, direct materials, wages and other overhead attributable to the development of new products. Amortization of these costs commenced August 1, 1997 upon commercial production and the certification of the new products. Costs are currently being amortized using the straight line method over a period of 5 years (Note 3).

If the project is cancelled or judged to be non-commercially viable, all deferred development costs will be expensed in the year of cancellation.

Research costs of a general nature are expensed during the year, net of related investment tax credits claimed, if such credits are reasonably expected to be utilized. See Note 1(f).

(f) Investment tax credits

Investment tax credits are recorded in the year they are earned provided there is reasonable assurance that the credits will be realized.

(g) Financial instruments

The Company carries a number of financial instruments. Unless otherwise indicated, it is management's opinion that the Company is not exposed to significant interest rate, foreign currency rate, or credit risks arising from these financial instruments. The fair values of these financial instruments approximate their carrying values, unless otherwise noted.

(h) Measurement uncertainty

The Company defers certain costs incurred on manufacturing contracts underway as work in progress inventory and accrues revenue based on a percentage of completion basis. These amounts are based on standard cost estimates for their material and labour components. Management has deferred these costs based on their best estimate given information currently available. Substantially all of the work in progress inventory on hand at May 31, 1999 and 1998 relates to the contracts for sale of satellite landing systems. As there is limited manufacturing history with regards to these new systems, the nature and amount of these estimates are subject to measurement uncertainty and actual results could materially differ from these estimates.

2. Inventory

	1999	1998
Raw materials	\$ 132,791	\$ 326,972
Work in progress	232,767	208,822
	<u>\$ 365,558</u>	<u>\$ 535,794</u>

Notes to Financial Statements – continued

3. Deferred Product Development Costs

The Company has deferred product design and development costs including direct labour, materials and other general and administrative overhead attributable to the development of the new generation satellite landing system, until August 1, 1997. Initially, the Company had adopted a policy to amortize these deferred costs on a unit of production basis over a period not to exceed five years. Commencing December 1, 1997, the Company changed its remaining estimate of useful life of these costs to 5 years. As a result, the net book value of these costs is being amortized using the straight line method over a period of 5 years (Note 1(e)). Amortization for 1999 includes an additional amount of \$1,018,052 which represents the write-down of remaining costs associated with technology research that has been superseded and is of no immediately realizable commercial value.

The costs deferred include:

	1999	1998
Design costs	\$ 1,282,280	\$ 1,282,280
Labour	749,111	749,111
Material	713,116	713,116
Other overhead	300,821	300,821
Interest and financing	35,153	35,153
	<u>3,080,481</u>	<u>3,080,481</u>
Less accumulated amortization	(2,085,421)	(492,223)
Cost less accumulated amortization	<u>\$ 995,060</u>	<u>\$ 2,588,258</u>

4. Capital Assets

	1999		1998	
	Cost	Accumulated Amortization	Cost	Accumulated Amortization
Machinery and equipment	\$ 1,170,036	\$ 623,680	\$ 1,302,341	\$ 646,876
Furniture and fixtures	434,479	197,194	692,924	359,766
Automotive	19,174	12,127	36,931	26,864
Leasehold improvements	168,673	124,269	168,673	99,083
	<u>1,792,362</u>	<u>957,270</u>	<u>2,200,869</u>	<u>1,132,589</u>
Cost less accumulated amortization	\$ 835,092		\$ 1,068,280	

Notes to Financial Statements – continued

5. Long-term Debt

Government of Alberta unsecured note repayable in monthly installments of \$3,500, beginning December 31, 1997 with a total repayment not to exceed \$75,000. Since December 31, 1997 this loan has been non-interest bearing. The remaining principal is due in July 1999.

	1999	1998
	\$ 12,000	\$ 54,000

Western Diversification unsecured program loan, repayable in \$5,000 monthly installments and quarterly installments of 6% of gross revenues in excess of \$1,000,000 from the sale of DME systems (Model 8900) sold between July 1, 1998 and May 31, 2000. The loan bears interest at 8.25%. All remaining principal and interest outstanding is due June 30, 2000.

	359,197	388,245
	371,197	442,245
	(198,928)	(430,245)
	\$ 172,269	\$ 12,000

Less current portion

Principal payments due in the next two years are as follows:

2000	\$ 198,928
2001	172,269
	\$ 371,197

6. Share Capital

(a) Authorized

Unlimited number of:
Common shares
First preferred shares, issuable in series
Second preferred shares, issuable in series

(b) Issued

	1999		1998	
	Number of Shares	Amount	Number of Shares	Amount
Common shares				
Balance, beginning of year	8,392,027	\$ 11,624,359	7,678,680	\$ 9,844,308
Issued for cash on exercise of options	-	-	96,250	230,485
Issued for cash upon exercise of warrants (Note 6(e)(i))	-	-	600,000	1,500,000
Issued in exchange for services	-	-	17,097	53,000
Share issue costs	-	-	-	(3,434)
	8,392,227	\$ 11,624,359	8,392,027	\$ 11,624,359

Notes to Financial Statements – continued

6. Share Capital - continued

(c) Employee stock options

The Company has established a stock option plan for the benefit of the directors, officers and employees of the Company. Options may be granted to purchase up to 10% of the common shares of the Company at any time at a price of not less than 90% of the current market price as listed on a stock exchange. If the common shares are not then listed on a stock exchange, the exercise price will be as determined by the Board of Directors of the Company.

During the current year, 551,000 stock options of the 561,750 options outstanding at the end of the previous year (exercisable at \$1.42 to \$6.95) were cancelled and re-issued (exercisable at \$1.16 to \$1.80) to certain directors, officers, and employees of the Company. In addition 117,000 options were issued during the year exercisable at \$1.16 to \$1.80. The Company also received board and regulatory approval to issue an additional 200,000 options to directors in lieu of cash compensation and 150,000 options with an exercise price of \$0.90 per share were issued as director remuneration. The balance of 50,000 options will be issued in the future for general purposes. Details of the options outstanding at the date specified are as follows:

As at May 31, 1999

750	at an exercise price of \$1.42 per share, expiring February, 2001
10,000	at an exercise price of \$6.50 per share, expiring August, 2001
503,000	at an exercise price of \$1.80 per share, expiring June, 2003
130,000	at an exercise price of \$1.55 per share, expiring June, 2003
25,000	at an exercise price of \$1.16 per share, expiring August, 2003
10,000	at an exercise price of \$1.46 per share, expiring November, 2003
150,000	at an exercise price of \$0.90 per share, expiring April 26, 2004
<u>828,750</u>	

As at May 31, 1998

750	at an exercise price of \$1.42 per share, expiring February, 2001
16,000	at an exercise price of \$6.50 per share, expiring August, 2001
86,000	at an exercise price of \$6.50 per share, expiring October, 2001
202,000	at an exercise price of \$6.95 per share, expiring November, 2001
2,000	at an exercise price of \$6.25 per share, expiring February, 2002
35,000	at an exercise price of \$5.85 per share, expiring May, 2002
25,000	at an exercise price of \$6.10 per share, expiring July, 2002
145,000	at an exercise price of \$5.30 per share, expiring October, 2002
50,000	at an exercise price of \$4.10 per share, expiring November, 2002
<u>561,750</u>	

(d) Contributed surplus

During 1996, the Company repurchased and cancelled 547,945 Series A preferred shares and related cumulative dividends unpaid of \$411,920 (\$380,000 cumulative and unpaid balance to May 31, 1996) for a purchase cost of \$400,000. The cancelled shares were recorded in the financial statements at \$756,808, resulting in contributed surplus of \$356,808.

Notes to Financial Statements - continued

6. Share Capital - Continued

e) Warrants and options

- (i) During 1997 the Company issued, on a private placement basis, 600,000 units at a price of \$6.00 per unit. Each unit consisted of one common share and one half share purchase warrant. Each warrant entitled the holder to acquire one share at \$6.90 per share on before October 25, 1997. 300,000 warrants were issued in 1997 and remain outstanding at May 31, 1998. During 1998, the Company made an application to extend the expiry date of these warrants to October 23, 1998. During 1999 all of these warrants expired and no new warrants were issued.
- (ii) During 1999, the Company issued 40,000 stock options to an individual under the terms of an investor relations agreement. These options are exercisable at a price of \$1.20 per share on or before November 1, 2003. In addition, the Company has reserved 27,000 common shares to be issued as a bonus to this individual upon completion of terms as per the investor relations agreement. The effective issue price of these shares will be the greater of the weighted average trading price of the shares for the previous 10 trading days and \$1.00 per share.

7. Income Taxes

The Company has research and development costs of \$6,501,200 (1998 - \$6,282,900) available to reduce future taxable income and investment tax credits of \$1,522,300 (1998 - \$1,580,800) available to reduce future taxes payable, subject to confirmation by taxation authorities. The investment tax credits expire in varying amounts over the years 2000 to 2008. The research and development cost pool will be reduced by the amount of any investment tax credits utilized. The Company had recognized and accrued \$529,481 of investment tax credits to May 31, 1997. In 1998, the Company wrote off these credits due to the uncertainty involved with their ultimate utilization.

The future tax benefits of the net research and development cost pools being carried forward have not been recognized in these financial statements.

Income taxes reported differ from the amount computed by applying the statutory federal and provincial income tax rates to income before income taxes. The reasons for these differences and their tax effects are as follows:

	1999	1998
Provision for income taxes based on statutory rate of 44.34%	\$ (1,440,392)	\$ (1,095,461)
Unrecognized benefit (utilization) of tax loss carry forwards	1,441,267	1,344,449
Write off of investment tax credits	-	(232,760)
Other	(875)	(16,228)
	<u>\$ -</u>	<u>\$ -</u>

The Company has incurred non-capital losses for income tax purposes of approximately \$3,794,000 (1998 - \$2,605,000) which are available to reduce taxable income in future years. If not utilized, these losses will expire approximately as follows:

May 31, 2001	\$ 21,000
May 31, 2004	1,536,000
May 31, 2005	1,048,000
May 31, 2006	1,189,000
	<u>\$ 3,794,000</u>

Notes to Financial Statements - continued

8. Commitment and Contingency

- (a) The Company is committed under the following leases for the rental of office and manufacturing space, with the aggregate yearly rental under the unexpired terms of these leases as follows:

	Calgary Property	Saskatoon Property
2000	\$ 79,167	\$ 32,307
2001	85,000	2,692
2002	49,583	-

- (b) A legal claim had been previously filed against the Company but a settlement was reached in the current year. A certain director of the Company personally settled this lawsuit at no further cost to the Company.

9. Segmented Information

As the Company's product lines all relate to the avionics equipment industry and are under common management, they have been aggregated as one operating segment.

Included in contract sales for the year are sales to the customers outside of Canada in the amount of approximately \$423,000 (1998 - \$1,818,000).

10. Economic Dependence

The Company has entered into an exclusive, long term teaming agreement with Honeywell Inc., a major supplier of avionics equipment, to develop, manufacture, install, maintain and market the Company's next generation satellite landing system. The majority of the Company's future sales will be generated pursuant to the terms of this agreement.

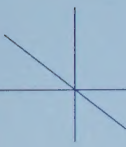
11. Financial Instruments

As disclosed in Note 1(g), the Company holds various forms of financial instruments. The nature of these instruments and the Company's operations expose the Company to foreign currency risk interest rate risk, fair value, and industry credit risks. The Company manages its exposure to these risks by operating in a manner that minimizes its exposure to the extent practical.

- (a) Interest rate risk management

The fixed interest rate debt is subject to interest rate price risk, as the fair value of debt will fluctuate as a result of changes in market rates. As at May 31, 1999, the Company had fixed interest rates on approximately \$339,000 (1998 - \$388,000) of its long-term debt obligations. The remaining \$12,000 (1998 - \$54,000) of long-term debt is non-interest bearing.

In addition, the Company also has the obligation to pay a specified percentage of future gross revenues as detailed in Note 5.



Notes to Financial Statements – continued

11. Financial Instruments - continued

(b) Foreign currency rate risk management

A significant portion of the Company's account receivable and accounts payable is denominated in U.S. dollars. Accordingly, the net amounts outstanding are subject to fluctuations in exchange rates. The Company does not have any exposure to highly inflationary foreign currencies.

(c) Credit risk

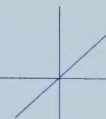
A significant portion of the Company's trade accounts receivable are from companies in the avionics equipment industry and as such, the Company is exposed to all the risks associated with that industry.

12. The Year 2000 Issue

The Year 2000 Issue arises because many computerized systems use two digits rather than four to identify a year. Date-sensitive systems may recognize the year 2000 as 1900 or some other date, resulting in errors when information using year 2000 dates is processed. In addition, similar problems may arise in some systems which use certain dates in 1999 to represent something other than a date. The effects of the Year 2000 Issue may be experienced before, on, or after January 1, 2000, and, if not addressed by the Company and its major customers, suppliers and other third party business associates, the impact on the companies' operations and financial reporting may range from minor errors to significant systems failure which could affect the companies' ability to conduct normal business operations. It is not possible to be certain that all aspects of the Year 2000 Issue affecting the Company, including those related to the efforts of customers, suppliers, or other third parties, will be fully resolved.

Corporate Information

(As at August 20, 1999)



BOARD OF DIRECTORS

Michael C. J. Beamish, P.Eng.
President & CEO
Pelorus Navigation Systems Inc.

Donald J. Douglas
President & CEO
United Inc.

Edward G. Fitzhenry
Chairman
Pelorus Navigation Systems Inc.

Terry R. Gibson
Portfolio Manager
Nesbitt Burns

Bruce C. Grant, P.Eng.
Partner
Quorum Funding Corporation

Kenneth C. Lett
President & CEO
Executive Flight Centre Inc.

John A. Lowe, CMC
President
Dreamcatcher Development Corporation

David L. Mitchell
President
Kairos Consultants

OFFICERS

Michael C. J. Beamish, P.Eng.
President & Chief Executive Officer

Geoffrey Bennett, CA
Vice President & Chief Financial Officer

Donald F. C. Sinclair
Vice President, Operations

TRANSFER AGENT AND REGISTRAR

The Montreal Trust Company
530 - 8th Avenue S.W.
Calgary, Alberta, Canada T2P 3S8

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Alberta Treasury Branches
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Calgary, Alberta, Canada T1Y 5S3

STOCK EXCHANGE

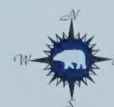
The Alberta Stock Exchange
Symbol "PN"

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PELORUS NAVIGATION SYSTEMS INC.



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